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FINANCIAL INSTITUTIONS DEVELOPMENTS

Fed's Announcement on Pay Practices Requires Immediate Action by Banks

The Federal Reserve has issued proposed guidance for banks on incentive compensation and has also announced the immediate commencement of special supervisory initiatives around pay practices, including what is likely to be a thorough review of incentive compensation.

The Federal Reserve has long been able to address compensation as part of its authority to regulate safety and soundness. Yesterday's announcement signals an unprecedented use of this authority to scrutinize pay practices, particularly at larger institutions, as an integral part of the supervisory relationship. Consistent with its recent focus on strong governance, the Federal Reserve guidance emphasizes the critical role of the board of directors in overseeing the design, implementation and review of incentive compensation arrangements.

All banking organizations are now expected to evaluate incentive compensation and related risk management, control and governance processes, and to address immediately deficiencies or processes inconsistent with safety and soundness. This is to be done with a view to the three core principles described in the proposed guidance – that incentive compensation should:

- not encourage excessive risk-taking beyond the ability to identify and manage risk
- be compatible with effective controls and risk management
- be supported by strong corporate governance, including active and effective board of directors oversight.

To help "spur and monitor" implementation of complying compensation programs, the Federal Reserve is undertaking two supervisory initiatives:

- For most banks, incentive compensation will now be specially reviewed as part of the regular risk-focused examination process.
- For 28 "large, complex" banking organizations, the Fed will conduct an extraordinary horizontal review of incentive compensation. This will involve reviewing documentation of an organization's current incentive compensation practices and its plans, including timetables, for improving the practices. Special supervisory attention will be given to the substance, effectiveness and timeliness of these improvement plans.

Compensation arrangements of supervisory concern include those of executive management and also of non-executives who, individually or as part of a group (e.g., loan officers), are able to expose the firm to material amounts of risk. Safe and sound compensation practices may well require safeguards beyond those considered best practices from the standpoint of shareholders. Supervisory findings on incentive compensation will be included in exam reports and incor-

porated into supervisory ratings. Enforcement action, including a requirement to develop a corrective plan, may be taken if incentive compensation or related controls, risk management or governance pose a risk to safety and soundness and acceptable curative measures are not being taken.

Organizations should immediately start to consider the resources and processes they will need in place to support these supervisory reviews. Multiple disciplines within the organization may need to be called on as well as traditional support areas such as human resources. The proposed guidance on incentive compensation, summarized in **Annex A** to this memo, may impact the processes and support functions institutions will need in place going forward – for example, the Federal Reserve suggests that:

- capital allocated to an activity be taken into account in assessing the appropriate amount of incentive compensation
- scenario analysis play a significant role in validating compensation strategies
- incentive compensation processes be subject to rigorous controls and be auditable.

The proposed guidelines expressly call for the involvement of functions such as compliance, internal audit and risk management in the incentive compensation process. Also, adjustments to incentive compensation strategies to reflect supervisory concerns will need to be made within an already complex environment, marked by the many highly technical tax rules applicable to compensation, TARP-related restrictions and the competitive realities of the market. It is therefore likely that both management and directors (the compensation committee) involved in setting compensation practices will need to evolve towards a more consultative and multidisciplinary approach, in particular during the adjustment period as a new compensation best practices evolves from the increased regulatory scrutiny on incentive compensation.

The Federal Reserve also plans to work with the SEC to improve disclosures to enable shareholders to monitor and, where appropriate, take action to restrain the potential for incentive compensation arrangements to encourage employees to take excessive risks. The new processes will undoubtedly impact disclosure in the Compensation Committee Report as part of the Company's Compensation Discussion and Analysis under the existing proxy disclosure rules.

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ANNEX A

Summary of Guidance on Sound Incentive Compensation Policies

Covered Individuals

- The guidance applies to incentive compensation arrangements ("ICAs") for:
  - Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
  - Individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk (e.g., traders with large position limits relative to the firm's overall tolerance); and
  - Groups of employees who are subject to the same or similar ICAs and who, in the aggregate, may expose the firm to material amounts of risk, even if no individual employee is likely to expose the firm to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

Principle 1 – Balanced Risk-Taking Incentives

- Amounts paid under an ICA should appropriately take into account the risks, as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness.
- Payments made under ICAs should vary based on risks or risk outcomes.
- Relevant risks include credit, market, liquidity, operational, legal, compliance and reputational risks.
- The full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, should be considered in assessing whether an ICA is balanced.
- ICAs that may encourage employees to take excessive risks should be modified to ensure that they are consistent with safety and soundness. Four possible methods are:
  - Risk adjustment of awards
  - Deferral of payment
  - Longer performance periods
  - Reduced sensitivity to short-term performance
- Each of these methods has its limitations and it may be acceptable to use a combination of these methods or a different method.

- ICAs should be tailored to account for the differences between employees as well as between banking organizations. A single formulaic approach may not be effective.

- Consideration should be given to the potential for "golden parachutes," the vesting terms of deferred compensation and "golden handshakes" to affect risk-taking behavior.

- The ways in which incentive compensation awards and payments will be reduced as risks increase should be effectively communicated to employees.

Principle 2 – Compatibility with Effective Controls and Risk Management

- Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk management and other functions, including:

  - Strong controls governing the process for designing, implementing, and monitoring ICAs; and

  - Sufficient documentation to permit an audit of the processes for establishing, modifying and monitoring ICAs.

- Appropriate personnel, including risk management personnel, should have input into the processes for designing ICAs and assessing their effectiveness in restraining excessive risk-taking.

- Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.

- ICAs should be monitored and revised as needed if payments do not appropriately reflect risk.

Principle 3 – Strong Corporate Governance

- The board of directors should actively oversee ICAs and should directly approve the ICAs for senior executives.

- The board of directors should monitor the performance, and regularly review the design and function, of ICAs.

- The boards of directors of banking organizations that are significant users of ICAs should review the arrangements on both a backward-looking and forward-looking basis.

- The organization, composition and resources of boards of directors should permit effective oversight of ICAs.

  - A compensation committee composed solely or predominantly of non-executive directors should have primary responsibility for overseeing the organization's ICAs.

- ➢ One or more of the directors should have a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities.

- A banking organization's disclosure practices should support safe and sound ICAs.

  - ➢ Shareholders should be provided with appropriate information regarding a banking organization's incentive compensation and related risk management, control and governance processes to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take excessive risks.

  - ➢ The Federal Reserve will work with the SEC to improve disclosures provided by public banking organizations in ways that promote the safety and soundness of these organizations.

- Large, complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation agreements and is supported by robust and formalized policies, procedures and systems.